# Operationalising Capital Account Liberalisation : Indian Experience*

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The objective of this paper is to narrate the Indian experience in operationalising capital account liberalisation. At the outset, the Indian context is described followed by a brief account of the factors that triggered the process of liberalisation in the 'nineties. The policy framework that governed liberalisation, the process of liberalisation and the current framework of controls are then explained. Subsequent sections describe the management of capital account and volatility in capital flows. The perceptions on the links between capital account, current account and, dollarisation are also mentioned. Other aspects relevant to capital account such as policy on reserve accumulation, exchange rate, monitoring of flows, dissemination of data and legal framework are elaborated in view of their significance for operational purposes. The current thinking on further steps towards liberalisation is briefly indicated. While recognising the stringent limitations on inferences based on experience of one country, some broad generalisations are made to enable meaningful discussion.

## Context

The country-context provides an essential background for approaching the process of operationalising capital account liberalisation. An initial step in understanding the Indian context is appreciating why strict capital controls existed till the reform of nineties. Firstly, in view of the colonial past, ' the public opinion since independence (1947) has been very guarded or suspicious about the presence of foreign trading interests or foreign capital, since national freedom was lost to the foreign traders who were licensed to trade in India by the then rulers. Secondly, as a natural consequence there are concerns about capital outflows also, reinforced by repeated stress on balance of payments often due to droughts, wars and supply shock, mainly oil. Thirdly, in this context and with the adoption of planned approach to development, the emphasis has been on utilising domestic savings for domestic investment; a logical extension of the preference for national economic self-reliance in trade. Fourthly, till ' eighties, influential assessment among policy makers was that the world trade was not open enough to permit strong export-led growth of a large economy like India. Usually, it was argued that strong protectionism will be put in place by industrial countries if "a thousand Singapores" are attempted by India.

Similarly, it was felt that, given the level of capital flows, which was mainly on official account, India's large needs may not be met in any significant way. In other words, possible quantities of capital inflows to India in that view, did not justify the risks of opening up the economy. Fifthly, it has also been felt that the domestic economy was endowed with a reasonable base of human skills, institutional social and physical infrastructure and diversified industrial base that the country could successfully launch on the path of self-reliance with relatively low level of economic dependence on the rest of the world.

Though there have been several international and domestic developments in the 'nineties to modify the country context indicated above, significant public opinion is not yet fully convinced that objective conditions have changed so dramatically that there should be complete reversal of

policy. In particular, the critics of liberalisation point out that in the traditional strategies that over ninety per cent of domestic investment has been financed by domestic savings and yet growth performance was not unimpressive. According to them, in the 'nineties, during the reform, foreign savings as a proportion of domestic investment has been no different, while on average, growth of Gross Domestic Product (GDP) was no more than in 'eighties. Further, it is argued that a large country like India would have faced serious threat to national social cohesion if a crisis like that of East Asia had taken place, and hence, the policy makers ought to be risk averse in regard to capital account. Finally, it is held that from geopolitical angle as well as the design and operation of international financial architecture, India is well advised to be cautious in estimating the international support for a bail out in times of international crisis. Many observers in India feel justifiably or not, that this caution is warranted by India's experience so far in the manner in which international financial markets have been assessing India, relative to other countries. The approach to and process of capital account in the recent years captures, as it should in a democratic set up, these diverse, but influential public opinions in the country.

**Control Regime**

It will also be useful in the country context to appreciate some of the characteristics of the control regime over the external sector. Soon after independence, a complex web of controls were imposed for all external transactions and these were controls over transactions in foreign exchange independent of trade or other policies and indeed, the control regime extended to all transactions between residents and nonresidents. In fact, a significant part of control regime to subserve the plan effort for development was built upon the framework of wartime (Second World War) control. These were put into a more rigorous framework of controls through a legislation in 1973 due to fears of capital flight. Severe restrictions on current account transactions continued till mid 'nineties when relaxations were made in the operations of the legislation of 1973 to enable convertibility on current account. It was only in June, 2000 that a legal framework to assure convertibility on current account has been put into effect.

Since the control framework was essentially transaction based (all transactions in foreign currency or between residents and non-residents were prohibited unless specifically permitted), it was equally valid for capital account, though the capital account itself was negligible till 'eighties. Most of receipts on capital account were on Government account and through external assistance in addition to the bilateral arrangement with erstwhile USSR. In the eighties, there were significant private capital ' flows through External Commercial Borrowings (ECB) and deposits from NonResident Indians (NRI). The factual position changed in the 'nineties, with gradual liberalisation of capital account though the overall legal framework for control over capital flows continue till the new legislation effective from June 1, 2000.

The formalisation of the shift in the external sector policy which commenced in early 'nineties is found in the preamble to the new legislation effective from June 1 which, *inter alia,* states that the objective of the legislation is facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India. This, effectively replaces the old Act whose relevant extract of Preamble reads as: "for the conservation of foreign exchange resources of the country and the proper utilisation thereof in the interest of the

economic development of the country." The details of new legal framework are described later in the paper.

## Triggering Liberalisation

India, after independence, opted for a model of development characterised by what was then perceived as self-reliance. Hence, till the early 'eighties, external financing was confined to external assistance through multilateral and bilateral sources, mostly on concessional terms to or through Government. In the 'eighties, global developments, particularly the perceptible decline in the availability of official concessional flows in relation to the external financing needs of developing countries, changed the external sector situation at a time when India was initiating liberalisation. The compulsions of repayments to the International Monetary Fund (IMF) during the late 'eighties (of the External Fund Facility (EFF) drawals in the early 'eighties) added to the problems. Hence, recourse to external debt on commercial terms became inevitable. In addition to institutional sources (such as Export-Import agencies), syndicated loans and bonds, and deposits from non-resident Indians were accessed. These had to be supplemented, in the late 'eighties with significantly large recourse to short term facilities including, in particular, short-term non-resident deposits. Most of these liabilities were on account of government or government owned enterprises or government owned financial institutions.

The onset of the 'nineties, however, saw the impact of the Gulf crisis on India. Combined with the large fiscal deficits of the 'eighties and political uncertainties, repercussions of this development in the Gulf resulted in drying up of commercial sources of financing and in what could be described as a severe liquidity crisis in the balance of payments. Another global dimension that affected India's management of the balance of payments during this period was the serious disruption of trade with the erstwhile USSR on top of worrisome recessionary tendencies in the industrialised countries and loss of export markets in West Asia. The crisis was overcome by a series of stringent measures with an overriding objective of honouring all external obligations, and non-reschedulement or non-prioritisation of any external payment obligation. While successfully meeting the Gulf crisis through an adjustment programme, it was decided to simultaneously launch upon a comprehensive programme of structural reform of which the external sector was one component.

## Policy Framework For Liberalisation

The broad approach to reform in the external sector after the Gulf crisis was laid out in the Report of the High Level Committee on Balance of Payments chaired by Dr. C. Rangarajan. The Committee recommended the introduction of a market-determined exchange rate regime while emphasising the need to contain current account deficit within limits. It recommended, *inter alia,* liberalisation of current account transactions leading to current account convertibility; compositional shift in capital flows away from debt to non-debt creating flows; strict regulation of external commercial borrowings, especially short-term debt; discouraging volatile elements of flows from non-resident Indians; full freedom for outflows associated with inflows (*i.e.,* principal, interest, dividend, profit and sale proceeds) gradual liberalisation of other outflows; and dissociation of Government in the intermediation of flow of external assistance.

The policy framework for the external sector based on the Rangarajan Committee Report was implemented along with policy changes in trade, industrial and financial sectors. Under trade policy, there has been a virtual elimination of licensing, a progressive shift of restricted items of imports to Open General Licence (OGL), and lowering of tariff barriers. Industrial policy has been characterised by delicensing, removal of monopoly clauses defining large industrial houses and removal of most reservations for public sector enterprises. The reforms in the area of financial sector were guided by recommendations of the Narasimham Committee (1991) appointed by Government. Alongside the deregulation of the banking industry including entry for new private sector banks, the general thrust of monetary policy has been towards reduction in pre-emptions, greater recourse to open market operations, deregulation of interest rates and widening and deepening of financial markets. Simultaneously, measures have been undertaken to strengthen the institutional framework in banking, non-banking financial companies, financial institutions and stock markets through prudential norms, capital adequacy stipulations, improvements in payments and settlement mechanisms and strengthening of the supervisory framework. Institutional measures have also included recapitalisation of banks, improvements in debt recovery and most important, setting up of the Board for Financial Supervision and strengthening Bank's supervisory mechanisms. A second Narasimham Committee (1998) has given a road map for further reform of banking sector, and a number of recommendations on prudential norms have been implemented.

Fiscal adjustment has been undertaken and a very significant measure is that the system of automatic monetisation of the fiscal deficit has been replaced by a system of Ways and Means Advances. In the recent Budget, the intention to promulgate a Fiscal Responsibility Act has been announced. The Act is in advanced stages of drafting.

In brief, reform in the external sector was coordinated with reform in other related sectors and within the external sector reform, capital flows are managed keeping in view the needs of efficiency and stability. There was a fairly smooth movement from an administered exchange rate system to a market-determined exchange rate. Reserve Bank attempts to ensure that volatility and speculative elements are curbed through both direct and indirect measures.

**Process of Liberalisation and Framework of Controls**

The Report of the High Level Committee on Balance of Payments, while providing the basic framework for policy changes in external sector, encompassing exchange rate management and, current and capital account liberalisation also indicated the transition path. Accordingly, the Liberalised Exchange Rate Management System involving dual exchange rate system was instituted in March 1992, no doubt, in conjunction with other measures of liberalisation in the areas of trade, industry and foreign investment. The dual exchange rate system was essentially a transitional stage leading to the ultimate convergence of the dual rates made effective from March 1, 1993. This unification of exchange rates brought about the era of market determined exchange rate regime of rupee, based on demand and supply in the forex market. It also marks an important step in the progress towards current account convertibility, which was finally achieved in August 1994 by accepting Article VIII of the Articles of Agreement of the International Monetary Fund.

The appointment of a 14 member Expert Group on Foreign Exchange (Sodhani Committee) in November 1994 was a follow up step to the above measures, for the development of the foreign exchange market in India. The Group studied the market in great detail and in its Report of June, 1995 came up with far-reaching recommendations to develop, deepen and widen the forex market as also to introduce various products, ensure risk management and enable efficiency in the forex market by removing restrictions, introducing new products and tightening internal control and risk management systems. Many of the subsequent actions were based on this Report.

Tarapore Committee on Capital Account Convertibility, 1997, appointed by the Reserve Bank of India, had recommended a number of measures while inviting attention to several preconditions. Among the various liberalisation measures undertaken in the light of these recommendations are those relating to foreign direct investment, portfolio investment, investment in Joint Ventures/wholly owned subsidiaries abroad, project exports, opening of Indian corporate offices abroad, raising of Exchange Earners Foreign Currency (EEFC) entitlement to 50 per cent, forfeiting, allowing acceptance credit for exports, allowing FIIs to cover forward a part of their exposures in debt and equity market, etc.

The current framework of controls need to be analysed from different angles for capturing operational reality. First, there is a differentiation between current (convertible) and capital account (subject to some controls) transactions. Second, there is a distinction and asymmetrical treatment between inflows (less restricted) outflows associated with inflows (free) and other outflows (more restricted). Third, residents are treated differently (more restrictive) than non-residents (less restrictive). Non-resident Indians have a well defined intermediate status between residents and non-residents. Fourth, there are also differences in treatment of individuals (highly restrictive), corporates (restrictive) and financial intermediaries such as Institutional Investors (less restrictive) and banks (more restrictive).

The instruments of controls are also varied and applied individually or in conjunction. Thus, some transactions are totally free, and some totally prohibited. The intermediate category ranges from prior approval on a case-by-case basis or an automatic basis. The application of automaticity of approvals or otherwise may be defined with reference to size of transactions, or purpose, or activity or parties concerned. The restrictions can also apply with reference to the financial instrument concerned. In some cases price-based (tax or reserve requirements) or administrative (interest rate ceilings) controls are used. The process of liberalisation is operationalised by the way the control framework is changed. Thus, movements from more restrictive to less restrictive take place from time to time based on both micro-experience and macro-policy environment. For example, in times of capital surges the pace of liberalisation of outflows is accelerated and vice-versa.

**Management of Capital Account : Procedures**

Based on the policy frame and the projected financing requirement for each year, management of the capital account is operationalised through procedures for external debt, non-debt flows and foreign currency outflows.

As regards inflows, it may be observed that the external debt on Government account is basically from bilateral and multilateral sources, with a long maturity. There are quantitative and several end-use restrictions of external commercial borrowings, and access is mainly to corporates and development financial institutions. There are severe quantitative restrictions on short-term borrowings also, excepting those strictly related to trade. Banks have access under prescribed quantitative ceilings. Deposits from non-resident Indians are accepted by banking system, and while non-repatriable ones are akin to domestic deposits, interest rates on repatriable ones are subject to ceilings. There is a more relaxed approach to Foreign Direct Investment, which contains two-routes, *viz.,* a gradually expanding automatic approval route and a gradually diminishing case-by-case approval. There is a very short prohibited list. Portfolio investments are restricted to selected players mainly for approved institutional investors. The taxes on short-term gains are higher than long-term gain. In addition, Indian companies are allowed to raise resources through Depository receipts subject to approval. There are no restrictions at all on outflows associated with permitted inflows. In respect of outflows, direct overseas investment is permitted through two routes, *viz.,* a case-by-case approval, and automatic list generally restricted to export earners. Resident individuals are virtually prohibited from holding financial assets in foreign currency.

**Managing Volatility in Capital Flows**

Between 1993 and now, even with a managed capital account, there were occasional bouts of inflows and outflows. In general, the short-term response to surges in inflows has taken a number of forms, *viz.,* raising of reserve requirements, reviewing the pace of removal of restrictions on capital inflows, relaxation of end-use specifications, liberalisation of capital outflows, partial sterilisation through open market operations, and deepening the foreign exchange market by routing an increased volume of transactions through the market.

At times of pressure on outflows, the RBI has resorted to both monetary and administrative measures to contain the pressure, apart from market operations to even out lumpy demand. These measures were undertaken mainly to even out the temporary demand supply mismatches. For instance, in order to encourage the faster realisation of export proceeds and to prevent an acceleration of import payments, the interest rate surcharge on import finance was raised, interest on overdue export bills was imposed, the scheme of post-shipment export credit denominated in foreign currency was scrapped. Monetary measures included increase in the Bank rate and repo rates and tightening of liquidity by raising cash reserve ratio. In order to mitigate fluctuation in exchange rate on account of large payments, payments on account of oil imports have been directly met out of reserves.

An extraordinary situation arose in 1998-99 consequent upon imposition of sanctions and the issue of Resurgent India Bonds (RIBs) is an interesting example of management of capital account in such a situation. The RIBs were designed to compensate for the extraordinary events in 1998-99, which may have resulted in some shortfall in the normally expected level of capital inflows in relation to the current account deficit which would continue to be well within 2 per cent of GDP. Due to the sudden developments in 1998-99, a temporary disruption in capital flows, especially debt flows was anticipated. Instead of dipping into currency reserves, which may affect sentiment adversely, or cutting the current account deficit through drastic import cuts,

which would affect real economic activity, the alternative was to enhance debt flows at the least possible cost. There was a need to offset the adverse negative market sentiment created in the international capital markets due to downgrading of India's sovereign rating to non-investment grade. This could be done by demonstrably raising debt resources at a cost lower than that any organised financial intermediary was prepared to provide in the context of the rating downgrade. Raising resources through sovereign borrowing was considered to be time consuming and in any case inadvisable as a maiden offering under adverse circumstances. At the same time, it was necessary to ensure that amounts so obtained were restricted quantitatively to meet essential needs as a replacement for normal debt flows by keeping an option for premature closure. Furthermore, it was necessary to ensure that the borrowing had appropriate medium-term maturity, say, five years. RIBs, which are essentially in the nature of foreign currency deposits on par with FCNR (B), were devised keeping in view these considerations. It was also necessary for the RBI to ensure that these funds do not disrupt the money, forex or Government securities market. A total amount of $ 4.23 billion has been mobilised at a moderate cost in a difficult international environment and in the face of recent downgrading of our credit rating.

**Link with Current Account and Dollarisation**

When India adopted current account convertibility in 1994, it was recognised, as emphasised by the Rangarajan Committee, that there could be capital outflows from residents in the guise of current account transactions. Hence, certain safeguards were built into the regulations relating to current account transactions.

First, the requirement of repatriation and surrender of export proceeds was continued. Exporters were however, allowed to retain a portion of their earnings in foreign currency accounts in India which could be used for approved purposes, thereby avoiding costs of conversion and reconversion.

Secondly, all authorised dealers were allowed to sell foreign exchange for underlying current account transactions, which could be readily identified and supported by some documentary evidence.

Thirdly, indicative value limits were given for different kinds of transactions so that the amounts sold were reasonable in relation to the purpose. For higher amounts, the banks had to approach the RBI. This operational framework for current account transactions strengthened the effectiveness of management of capital account.

On dollarisation, it was recognised that large scale dollar denominated assets within a country can disrupt the economy by creating potential for destabilising flows. No Dollar denominated transactions are generally allowed between residents. Exchange earners' foreign currency accounts can be used only for external payments and if such balances have to be used for local payments, they have to be converted into rupees.

The counterpart of dollarisation is internationalisation of domestic currency. For example, there are instances when a currency of a developing country could be officially traded outside the country without any underlying trade or investment transactions. When such currencies are held

increasingly outside the country and there is multiplication of such holding, any expectation that there will be a fall in the currency due to fundamentals or contagion leads to widespread sell off which results in very sharp fall in the currencies especially when the local markets are not well developed. India does not permit rupee to be transacted offshore, *i.e.,* Rupee is not allowed to be officially used as international means of payment or store of value. Indian banks are not permitted to offer two way quotes to NRIs or non-resident banks.

A highly conservative approach is adopted with reference to dollarisation of domestic economy and internationalisation of domestic currency.

**Policy on Reserve Accumulation**

Reserves have been steadily built up by encouraging non-debt creating flows and de-emphasising debt creating flows. It is recognised that a level of reserves that satisfies the need for liquidity and offers insulation against unforeseen shocks is reasonable. Foreign exchange reserves are kept at a level, which is adequate to withstand both cyclical and unanticipated shocks. The liquidity needs are assessed over various time horizons *viz.*, on a daily basis, on a weekly basis as well as on a monthly basis. The long run perspective on the liquidity is also under constant review by ensuring that the reserves are adequate enough not only in terms of conventional norms like import cover, but also in terms of debt servicing, stock of short term debt and portfolio investment.

The essence of reserve management being safety and liquidity and optimisation of returns, all investments made of reserves are of top quality and excellent liquidity. Liquidity risk is also mitigated to a large extent by keeping a good proportion of reserves invested in those assets/deposits, which are of top credit quality and convertible into cash at short notice. There is a rigorous system of internal rating of the institutions and instruments in which reserves are invested. The counterparties with whom deals are conducted are also subject to screening. These ratings are reviewed on an on-going basis. Also, since capital flows are closely monitored and contacting of debt itself is controlled, there is an in-built safeguard.

**Exchange Rate Management**

The exchange rate is determined by the market, *i.e.,* forces of demand and supply. The objectives and purposes of exchange rate management are to ensure that economic fundamentals are reflected in the external value of the rupee as evidenced in the sustainable current account deficit. Subject to this general objective, the conduct of exchange rate policy is guided by three major purposes.

First, to reduce excess volatility in exchange rates, while ensuring that the movements are orderly and calibrated.

Second, to help maintain an adequate level of foreign exchange reserves.

Third, to help eliminate market constraints with a view to the development of a healthy foreign exchange market.

Basically, the policy is aimed at preventing of destabilising speculation in the market while facilitating foreign exchange transactions at market rates for all permissible purposes.

The Reserve Bank of India makes sales and purchases of foreign currency in the forex market, basically to even out lumpy demand or supply in the thin forex market; large lumpiness in demand is mainly on account of oil imports and external debt servicing on Government account. Such sales and purchases are not governed by a predetermined target or band around the exchange rate.

**Monitoring**

The RBI closely monitors the foreign currency mismatch and open foreign currency and gold positions of banks. The foreign currency/gold maturity mismatch limits and open foreign currency positions are vetted by the RBI. The open foreign currency position is applicable for all currencies put together using shorthand method, *i.e.,* the higher of the total short or long positions. No limits have been placed for individual currencies. While vetting these limits, the RBI ensures that these have a reasonable relation not exceeding an internally laid down limit to Tier I capital funds of the bank.

Besides vetting limits on open foreign currency and gold positions and maturity mismatches, the RBI had prescribed capital requirements for market risk on open foreign currency positions. Banks are required to add the open position limit to total risk weighted assets and maintain the required capital adequacy ratio.

**Dissemination of Data**

India is one of the earliest subscribers to the SDDS of the International Monetary Fund. In this section the focus is on state of transparency in regard to the external sector statistics. The RBI publishes detailed data on external sector in its Annual Report and the Report on Currency and Finance, annually.

The Balance of Payments data is published in the monthly bulletin on a quarterly basis with a three-month lag.

The Weekly Statistical Supplement to the RBI Bulletin contains data on monetary and financial aspects as well as the external sector. In the external sector, the daily exchange rates, spot and forwards and the weekly forex reserves position are given.

The total external debt of India is compiled and published by the Ministry of Finance and the RBI at different frequencies. The Ministry of Finance publishes data annually in the form of "Status Report" and in the Economic Survey, which are public documents. These Reports provide information on multilateral, bilateral and commercial debt and identifies Government debt separately. The data includes debt for defence purposes, rupee-denominated debt and NRI deposits. Sources of data are reporting by Government, corporates concerned and banks, compiled by the Ministry of Finance and the Reserve Bank of India. Since all external

borrowings need approvals, the quality of data is reasonably sound. Currently, the data is reported on original maturity basis.

The data on foreign investments, both direct and portfolio, as well as data on outstanding balances under various nonresident deposit schemes are published on a monthly basis in the RBI Bulletin. This is in addition to trade data. The Reserve Bank of India disseminates data on forex reserves on a weekly frequency with a lag of one week. Data is given separately with regard to foreign currency assets and SDR and gold holdings. Information on sale and purchase of foreign currency by the RBI as also information on forward liabilities of the central bank are disseminated to the public on a monthly basis, with a lag of one month. The dissemination of data on forex reserves is through the Weekly Statistical Supplement and the monthly RBI Bulletin, which are also available on the RBI website.

The Reserve Bank also publishes the 5-country and 36-country NEER and REER on a monthly basis with a lag of one month.

Recently, the Government of India has set up a National Statistical Commission to examine the deficiencies of the present statistical system in the country with a view to recommending measures for a systematic revamping of the system. One of the subgroups is looking into financial and external sector statistics. The subgroup has already identified aspects of external sector data that require further refinements, and initiated follow-up action to bridge the data gaps.

**Legal Framework**

The Foreign Exchange Regulation Act (FERA) has been replaced by Foreign Exchange Management Act (FEMA) with effect from the beginning of this month, *i.e.,* June 2000. The philosophy of foreign exchange management has shifted from that of conservation of foreign exchange to one of facilitating trade and payments as well as developing financial markets. This definitive shift in the objectives of foreign exchange management will automatically get reflected in the operations of the Reserve Bank. There is a clear distinction between the current and capital account. Under the new system, all current account payments except those notified by the Government are eligible for appropriate foreign currency in respect of genuine transactions from the Authorised Dealers without any restrictions. The surrender requirements in respect of exports of goods and services continue to operate. The Reserve Bank however, would have the necessary regulatory jurisdiction over capital account transactions. To this extent, further action in regard to capital account liberalisation appears to have been put by Government squarely in the court of the Reserve Bank of India.

It must be noted that the new legal framework keeps the option of reimposing controls, capital or current account if it becomes necessary. Thus, the Central Government is vested with the power to suspend and revoke any permission granted if the Government is satisfied that circumstances warrant such actions, in public interest.

**Capital Account Convertibility - Further Steps**

The committee on Capital Account Convertibility (CAC), with Dr.S.S.Tarapore as Chairman, which submitted its Report in May 1997, observed that although there were benefits of a more open capital account, international experience showed that a more open capital account could also impose tremendous pressures on the financial system. Hence, the committee indicated certain signposts or preconditions for capital account convertibility in India.

The three crucial preconditions were fiscal consolidation, a mandated inflation target and above all, strengthening of the financial system. The committee recommended a reduction in Gross Fiscal Deficit / Gross Domestic Product ratio from 4.5 per cent to 3.5 per cent in 1999-2000 and a mandated rate of inflation for the period 1997-98 to 1999-2000 at an average of 3 to 5 per cent. In the financial sector, the time frame for signposts that were recommended was in terms of Cash Reserve Ratio (CRR) and Non-Performing Assets (NPAs). The recommendations were to reduce gross NPAs of banks as a percentage of total advances from 13.7 per cent in 1996-97 to 9 per cent by 1998-99 and to 5 per cent by 1999-2000, and the average effective CRR from 9.3 as of April 1997 to 3 per cent by 1999-2000.

The process of convertibility on the capital account has been gradual and as the experience shows there is a hierarchy to it. There is a differentiation between inflows and outflows and within this between corporates, individuals and banks. Currently, the priority is to liberalise inflows, and in particular on corporate account. The recent freedom given to corporates to raise funds through ADRs/ GDRs is a signal to this effect. All outflows associated with inflows are totally free. With regard to liberalisation of outflows the hierarchy is corporates, financial intermediaries and individuals, although Tarapore Committee preferred liberalisation of flows on individual account earlier in the hierarchy. It would, therefore, be reasonable to expect some liberalisation on outflows with regard to corporates in the near term, and in regard to banks and other financial intermediaries after some progress in financial sector reforms.

On the path towards capital account convertibility, there is now a lot more stronger public opinion and the issue is more of a technical judgement on sequencing rather than whether to open up or not. Between the preconditions and the time frame for CAC recommended by the committee, it is clear that the achievement of preconditions has emerged, as perhaps intended, the more important criterion for liberalizing the capital account, while the timetable itself has lesser significance. Thus, the pace of liberalisation of capital account would now depend on domestic factors, especially the progress in financial sector reform and the evolving international financial architecture.

**Some Generalisations**

The introductory part of the paper dealt with the importance of country context and hence, any inferences based on the country experience described should be either totally eschewed or viewed with great circumspection. With this cautionary note, some broad generalisations are attempted here. The generalisations are somewhat narrowly focussed on the external sector and not the broader macro-policy issues such as implications for monetary management and exchange rate policy.

First, the current account deficit represents the use of external resources in a country. Capital inflows to finance such deficits are welcome for their role in financing investment, and thereby sustaining long-term development. At the same time, it should be apparent that a large current account deficit implies correspondingly a large dependence on such capital inflows. The developing countries are vulnerable in many spheres and hence such large dependence has a potential for destability. The issue is not whether there are inflows or outflows at a point of time, since a fall in inflows is enough to cause a crisis when there is large dependence. It is precisely with this view that India resisted the urge to allow current account deficit to exceed around 2 per cent of GDP in India. No doubt, the level of normal capital flows or sustainable current account deficit is contextual- to the country concerned, level of development, extent of external sector and even geo-political considerations. Briefly stated, for developing countries, non-volatile flows are ensured only if current account deficit is sustainable and policy makers need to constantly review the sustainability.

Second, there is a trade-off in the short run between financial stability and efficiency which all policy makers are aware of. More the prudential regulations, greater is the cost of intermediation, though in the long-term it is the stability that imparts efficiency. In search of higher efficiency gains in one stage of development, a country may accept the risk of greater volatility. But, the trade-off has to be viewed in a contextual sense in relation to both domestic policy stance and the international environment. There is an impression that in the light of the Asian experience, policy choice should in future tilt totally in favour of stability at the cost of efficiency. While the crisis has drawn attention to the risks, and inadequacies in international financial systems, there is a greater global awareness of the issues now. In other words, the relative weights to efficiency and stability needs to be constantly reviewed with reference to both domestic and international developments.

Third, in the context of normal flows, one way of giving a greater weight to stability would be emphasising longer term flows. The issue would of course be how to distinguish between long-term and short-term. It is necessary to recognise the existence of a hierarchy, however, difficult to achieve. From a purist's point of view, an efficient system of financial intermediation would require easy movements and transmission mechanisms. But, the cross border flows, with all the globalisation, are not subject to the same logic as domestic flows. True, the presumed differences between portfolio flows and FDI flows can be overdone as FDI flows can also be volatile. Longer maturity external liabilities may seem less vulnerable to volatility than short maturity ones but if there are active secondary markets, long maturities may be highly liquid. Similarly, there are also different points of view regarding the risks involved in debt and equity. Foreign owners of equity can choose to exit although a falling market or depreciating currency should provide a disincentive, but not if there is herding. Yet experience has shown that FDI has a tendency to be less volatile, because the original motivations for inflow is both financial and non-financial. Further, there is also a gestation period, *i.e.,* project completion, which is built into the profit projection and thus imparting stability. Hence, there is merit in giving greater weight to FDI than portfolio in deciding what is relatively long-term.

Fourth, the treatment of trade related flows for defining short-term debt assumes importance. It is important to distinguish between trade credit, which provides a rather stable source of financing even though each individual loan has a short maturity and other types of short-term borrowing. It

is also essential to capture the leads and lags in trade related payments that affect the level of short-term debt.

Fifth, while the size and maturity structure of debt are important, bunching of repayments is critical. In this context, the impression that all long-term debt is a panacea may not be totally correct. The approach should not be merely to contain certain debt under all circumstances, but to moderate the size and changes in debt flows. Keeping the external debt within limits has a role in avoidance of financial crisis, but bunching of repayments has a potential to create liquidity problems.

Sixth, it would do well for authorities to continuously monitor the level of private sector debt and the positions that are taken by them. Since large transactions have the potential to disrupt the market, it is better to keep a tab on such transactions. Financial institutions have to be sensitised for monitoring unhedged positions of corporates.

Seventh, there is need to be careful on dollarisation of the economy. It is now recognised that large scale dollar denominated assets within a country can disrupt the economy by creating a potential for destabilisation.

Eighth, the discipline of releasing timely data, compels the authorities to be lot more accountable and markets to be less prone to surprises. The data dissemination should be regular, relevant, timely and authentic though such transparency does not eliminate the risk of wrong inferences by market participants.

Ninth, skills of market participants as well as regulators have to be continuously upgraded in order to keep pace with developments in technology and innovations in market if both policy changes and responses are to be effective. There is in some senses a big dilemma here. Controls are imposed because markets are imperfect and participants' skills are inadequate; but markets do not get less imperfect and participants' skills do not improve as long as controls exist. The interactive process is critical here.

Tenth, the nature of relationship between different financial markets is important. It is now recognised that capital account liberalisation should not be undertaken without a strong financial sector since the strength of the financial sector has systemic implications. It is not appropriate to assume that since markets are developed they are integrated fully. There can be varying patterns of integration. Thus, opening of capital account should take into account specific country circumstances while establishing strong legal, regulatory and institutional framework. An added dimension, of course is the developing international financial architecture. Thus, the pace and sequencing have to be determined by both domestic and international developments.

Eleventh, whether the liberalisation of capital account should totally foreclose the option of imposing controls? It is perhaps wise for many developing countries to have the legal framework for reimposing controls in times necessity and keep the policy option open both for prudential and *ad hoc* controls. Such options for domestic actions are warranted as long as international financial system imposes unequal burdens between domestic economy and market participants in the event of volatility.

Finally, and an issue that is often raised relates to the speed with which a country should open up. As would be evident from the description in the paper, the issue of liberalisation of capital account cannot be approached in isolation. The degree of sustainable openness, in some ways, depends on productivity and prospects for improvements in productivity in the real sector. Even more important, it would depend on the size and structure of domestic economy, the political economy of the country concerned and the assurances of stability and support when needed, from international financial system. As of now, the burden of crises arising out of capital account appears to be predominantly on the residents. In sum, capital account liberalisation has both a national and international context - a truism indeed.

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